Financing the Millennium Development Goals for Water and Sanitation: What Will It Take?

Prepared as a synthesis paper for the Finance stream for the Global WASH Forum 2004 in Dakar, Senegal
Financing The Millennium Development Goals
For Water And Sanitation:
What will it take?

Sector finance issues to address at the WASH Forum

This paper is prepared by WSP-Africa to guide discussions on the characteristics of financing requirements, affordability and feasibility of the Millennium Development Goals (MDGs) on water and sanitation. It argues that for developing countries to meet the water and sanitation targets, they will need to use public resources better so as to increase sector performance, help the poor gain access to water and sanitation and leverage more resources into the sector.

The paper puts forward the following sector finance issues for tackling the financing challenge in meeting the MDGs on water and sanitation and discusses key areas of actions:

What are the financing requirements, and affordability and feasibility of reaching the water and sanitation MDGs?

- What defines country level investment and financing requirements? How can they be assessed better to be more useful to decision-makers and for overall planning?
- How are countries assessing and tackling constraints of affordability? How do they identify feasible levels of public and total sector expenditure, and provide appropriate incentives for cost-effective technology and service level choices?
- How are countries tackling capacity constraints, especially at local level and under decentralization? What are the possible support mechanisms for strengthening capacities?

What actions are needed to improve priority for and the use of public resources?

- What efforts are made to give water and sanitation priority in national planning (PRSPs) and public allocations, and what support is required to increase this priority?
- What are countries doing to improve allocation principles and efficiency in the use of public resources?
- What measures and financing mechanisms are necessary to ensure that public money is used effectively in increasing access to the poor and the disadvantaged?

How to leverage additional non-public resources into the sector?

- How can more community contributions (capital and operations and maintenance) be leveraged - and what measures are required to increase this source of finance?
- How can internal cash generation among utilities be improved and their creditworthiness enhanced to raise capital in the domestic credit markets? What support structures are necessary for facilitating this?
- What measures are necessary to support mobilization of resources by small private sector in service delivery and to support private sector contribution in improving efficiency of other service providers?
1. Introduction

The world is on track towards meeting the Millennium Development Goal (MDG) for access to safe drinking water at a global level: current coverage stands at 83 percent. But for Sub-Saharan Africa the situation is grim. About 400 million more people need to gain access to improved water before 2015 for Sub-Saharan Africa to reach the MDG target for water. The global state of sanitation is worse: sanitation coverage expansion has stalled in most developing countries, where some 2.6 billion people live without access to appropriate sanitation.1

Global estimates of finance requirements for the water and sanitation expansion point to large funding gaps. But as the Global WASH Forum theme suggests, the immediate challenge is for countries to set country-specific targets and translate global goals into local targets, and strategies for both the water and sanitation sub-sectors and for rural and urban service delivery: “Water, Sanitation and Hygiene for all – Solutions and actions; local and national”.

This paper discusses the financing requirements, affordability and feasibility of reaching the MDGs. It argues that for African countries to meet the water and sanitation targets, they will need to implement cost recovery policies and use public resources better so as to increase sector performance, help the poor gain access to water and sanitation and leverage more resources into the sector.

2. Financing requirements, affordability and feasibility of the MDGs

Numerous efforts have been made to estimate the total costs of reaching MDG targets. The Camdessus Panel2 approximates that global investments required to meet the drinking water target stood at about US$13 billion per annum. Sanitation requirements were estimated at US$17 billion per year. But these figures may underestimate the total requirements as they do not take into account wider sector management costs as well as operations and maintenance costs of existing capital stocks.

Expenditure for meeting the MDGs comprises three main components. First, increased access requires new infrastructure and rehabilitation of non-functioning infrastructure. Second, adequate allowance must be made for operations and maintenance of new and existing infrastructure stocks. Finally, finances are required for sector development, including activities such as capacity building in communities, policy formulation and standard setting, and sector monitoring and regulation.

For giving guidance to the discussion of the characteristics of the financing requirements, affordability and feasibility at the WASH forum, this section presents the results from a simple cost analysis for the Sub-Saharan African region, with some illustrative requirement comparisons for Bangladesh and India3. This is to shed light on regional and common issues in the sector across countries, not to be taken as country level estimates, which would require more detailed discussion of local technology choices, cost recovery policies and priority in public expenditure.

1 Joint Monitoring Program 2004.
2 Winpenny 2003.
3 Results from these two countries are based on Kabir 2004 and Roberts and Kapur 2004.
Table 1 provides estimates of water and sanitation expenditure requirements for Sub-Saharan Africa. Using unit cost estimates from JMP 2000, and assuming that operations and maintenance costs amount to 10 percent of the replacement value of installed infrastructure and sector development costs of two percent, the total annual expenditure requirement in the sub-Saharan African water sector is in the order of US$3.3 billion per year. Total expenditure requirements to reach the sanitation targets in Africa almost match - about US$3.4 billion per annum - assuming that a large proportion of the population will depend on simple and improved pit latrines, rather than water-borne sewerage. The annual requirement will increase over time due to increasing capital stocks, as coverage increases, thereby increasing operations and maintenance costs.

### Table 1: Annual expenditure requirements to meet the MDGs in Sub-Saharan Africa (2002)

<table>
<thead>
<tr>
<th></th>
<th>Capital Investment</th>
<th>O&amp;M</th>
<th>Sector Mgt</th>
<th>TOTAL</th>
<th>% required in rural</th>
<th>Requirements as a % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Water (B$/yr)</td>
<td>1.1</td>
<td>1.8</td>
<td>0.4</td>
<td>3.3</td>
<td>35.8%</td>
<td>1.3%</td>
</tr>
<tr>
<td>Sanitation (B$/yr)</td>
<td>1.5</td>
<td>1.5</td>
<td>0.4</td>
<td>3.4</td>
<td>55.5%</td>
<td>1.4%</td>
</tr>
<tr>
<td>Total</td>
<td>2.6</td>
<td>3.3</td>
<td>0.8</td>
<td>6.7</td>
<td></td>
<td>2.7%</td>
</tr>
</tbody>
</table>

Source: Calculations as per assumptions described in the text and in footnote 4 and using on information from World Bank 2004, Joint Monitoring Program 2000 and 2004.

In order to meet the MDGs, these expenditures will need to be met from different sources. There is an emerging consensus among most stakeholders that all operations and maintenance expenditures need to be met through user charges, while public expenditure through government budgets should largely focus on sector management and partial grants for capital investments with varying levels of capital costs sharing by consumers and utilities. A country’s affordability to meet these will depend both on total economic capacity (as defined by GDP) as well as level of public expenditures. This approach to analysis of the expenditure requirements and affordability provides a number of insights:

**Total finance requirements are sensitive to choices in technology and level of service, and costs of technology, operations and maintenance and sector management.** The results in Table 1 are based on several assumptions that would vary depending on the country situation, and do not take into account variations in the cost of service in relation to demographic factors, natural condition, coverage level and level of service. In the baseline estimate the technology mix includes some house connections in rural and urban areas, and waterborne sewerage in urban areas.

Figure 1 illustrates the implications of changes in technology mix and service levels, unit costs and cost of sector management. The fall in cost due to changed technology and service level mix is moderate because of the conservative baseline estimate. Reductions in unit (capital) costs yield similar results. A ten percent decrease in unit costs, reduces the total requirement by ten percent, equal to 0.3 percentage points of GDP. The total cost is also sensitive to changes in sector management requirements. If the

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4 These are first round requirements estimates. More work is needed to especially understand the costs of sanitation i.e. hygiene promotion etc.

5 Unit costs for operation and maintenance and for sector development are difficult to arrive at, given wide variations dependent upon a number of variables. These estimates assumed, conservatively, that the total costs of operations and maintenance and sector development were similar to the costs assumed in JMP 2000, but applied these costs to both new and existing infrastructure, rather than new infrastructure alone.
sector management costs are increased to 4 percent, double of the baseline estimate, the total costs is increased from 2.7 to 3.0 percent of GDP for both water and sanitation.

**Figure 1: Impact of technology choices and changes in unit and sector management costs**

There is a need for detailed national level costing and financial planning, because in-country requirement estimates vary significantly in relation to country level technology mix, unit costs and service standards. This simple analysis clearly illustrates that efficiency gains in service delivery are critical, and that the cost of sector management is important to recognize. However, detailed country level analysis is necessary for arriving at more appropriate levels of spending. In Zambia for example, a working group estimated that the finances to the sector needed to double. However, this analysis shows that current supply of finance in the sector in Zambia in fact outweighs demand (Table 2). The same is true for Ethiopia. Requirement estimates in Ethiopia suggest a capital investment requirement of about US$150 million per year to meet the water MDGs – about 25 percent more than estimates in this analysis. But there is also a need to strengthen the efforts to explore sector expenditure requirements under different scenarios. WSP Africa is currently developing a tool for this that is being tested in consultation with the Government of Kenya.

**Finance requirements generally put more stress on poorer countries.** The finance requirements to meet the water and sanitation MDGs in African countries vary considerably. One way to assess affordability is to review these in relation to the country’s total income. On an average the requirement for water sector finance is 1.3 percent of GDP and 1.4 percent for sanitation. Figure 2 shows the variation in total sector expenditure requirements for meeting the water MDGs across African countries. Ethiopia, Burundi, Democratic Republic of Congo, Guinea-Bissau, Sierra Leone and Liberia all require over 2.5 percent of GDP, double the continent’s average, to finance the attainment of the water MDGs in their countries. Wealthier countries, such as Botswana or South Africa, however, require only 0.2-0.3 percent of GDP. Expenditure for meeting MDGs on water, relative to GDP, decreases with increasing GDP per capita. Poorer countries, therefore, are required to spend more in achieving targets as a percentage of GDP. The same is true for sanitation.

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7 This tool (SWIFT – sector-wide investment and financing tool) aims to provide an easy computer-aided analysis for testing various policy scenarios in consultation with country sector institutions and different stakeholders.
Potential expenditure shortfalls in the sector are apparent in some countries when requirements are compared to current sector expenditures. Unlike the health sector, detailed studies and estimates of total sector spending are not available for different countries. However, based on studies in five countries in the region, current expenditures in the water sector range from about 1.0 to 1.9 percent of GDP, suggesting an average level of 1.4 percent of GDP (Table 2). The three out of the five countries in the analysis may not be spending enough towards meeting the MDGs. Though this sample is not representative for the region, it suggests that in some countries current expenditure levels fall short of what is required, especially in the poorer countries.

**Table 2: Total sector expenditure and finance gaps to meet the MDG targets on water in five African Countries**

<table>
<thead>
<tr>
<th>Expenditure (M$/year)</th>
<th>Ethiopia</th>
<th>Kenya</th>
<th>Uganda</th>
<th>South Africa</th>
<th>Zambia</th>
</tr>
</thead>
<tbody>
<tr>
<td>% on capital expenses</td>
<td>61%</td>
<td>48%</td>
<td>-</td>
<td>21%</td>
<td>43%</td>
</tr>
<tr>
<td>% on recurrent expenses</td>
<td>39%</td>
<td>52%</td>
<td>-</td>
<td>79%</td>
<td>57%</td>
</tr>
<tr>
<td>Total sector spending (% of GDP)</td>
<td>1.2%</td>
<td>1.0%</td>
<td>1.7%</td>
<td>1.9%</td>
<td>1.9%</td>
</tr>
<tr>
<td>Finance gap (% of GDP)</td>
<td><strong>1.9%</strong></td>
<td><strong>0.2%</strong></td>
<td><strong>0.1%</strong></td>
<td><strong>-1.7%</strong></td>
<td><strong>-1.1%</strong></td>
</tr>
</tbody>
</table>


The shortfall may be moderate with regard to capital investment. Expenditure as a percentage of GDP on capital investments in the sector varies from country to country: Ethiopia (0.76), Kenya (0.44)

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8 A word of caution is necessary. These are best-judgment estimates given the difficulty in assessing off-budget resources (NGO expenditure) and at times even public spending in the sector. The studies did not manage to capture self-financing at household level. This is even more true for sanitation given the fragmented nature of public finance and the significant degree of self-supply.
Financing The MDGs For Water And Sanitation

and Zambia (0.80). Only in Ethiopia is there a shortfall in finances according to this analysis of annual capital expenditure requirements to meet the MDGs. These findings indicate that though capital requirements are significant, the countries may already be allocating adequate resources to capital investments. It is important to acknowledge however, that this analysis assumes a low level of service and excludes any costs associated with rehabilitation of existing infrastructure. This analysis for Africa also suggests that the magnitude of the requirement and spending is high compared to countries in other regions. In Bangladesh, for example, the capital requirement for meeting the MDGs, amounts to about 0.10 percent of GDP, while in India, it amounts to only 0.03 percent.10

The operations and maintenance expenditure will rise over time; countries need to spend sufficiently on maintenance while ensuring value-for-money in operation and delivery of service. This analysis also suggests a shortfall in operations and maintenance expenditure. In the water sector, average requirements will increase over the period (2002-2015) from 47 percent of total finance requirements to 54 percent. The requirement for operations and maintenance spending varies by country however, with low coverage countries, such as Ethiopia, requiring as little as 32 percent of sector financial demands to fund operations and maintenance. In line with the consensus on cost recovery, this expenditure needs to be met through user charges so that public funds are focused on expanding coverage. It is also critical to choose appropriate service levels to maximize the cost recovery potential. For example, a study in Morocco11 showed that users in shantytowns were willing to pay significant share of their income if their service levels were upgraded from standpipes or community taps to house connections.

All sources of funds need to be maximized and used appropriately for reaching the targets. The second aspect of country level affordability is linked to the level of public expenditure requirements. Even if public money is only spent on sector management and limited to 90 percent of annual capital investment outlays in rural and 30 in urban to expand coverage (with operations and maintenance costs recovered fully through user charges), on average the public finance requirements will amount to about three percent of total national public expenditure - quite high compared to current levels varying from about 1.3 to 2 percent in Kenya and Ethiopia.12 Also, the sector has ‘hit the medium-term expenditure framework (MTEF) prescribed ceiling’ in Uganda, and projected level of public expenditure may not be forthcoming. This points to a number of policy implications. Only those countries with relatively higher income and a solid tax base can afford the relatively high subsidies/grants in the sector. For most countries it is essential to identify fiscally sustainable subsidy/grant levels, as well as provide appropriate incentives for cost-effective technology and service level choices.

Capacity to absorb funds into the sector needs to be improved, especially at local level. While increased funds will be needed to meet sector expenditure requirements in some counties, the capacity to use the funds effectively in the sector may be a constraint, especially where the expenditure levels need to

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9 See the sources for table 2.
10 The India investment estimates are based on averages of projected outlays in the 10th Five Year Plan and the UNICEF/WHO/PC estimates for reaching the MDG targets as presented in Roberts and Kapur. It was difficult to determine the proportion of operations and maintenance in the cost scenarios. The figures reported are for 2003.
12 This analysis uses the average spending figures for Sub-Saharan Africa for illustrative purposes, and is based on data for only 12 countries. Sources for Ethiopia and Kenya are: WSP-AF 2004a and 2004b respectively.
more than double. Ethiopia for example faces human resource constraints, especially in rural areas. Often, sector expertise is clustered in major cities where incentives are greater. Appropriate incentive structures must be developed to strengthen local capacity for additional responsibilities under decentralization. Local institutional responsibilities and capacities for service responsibilities must also be matched with availability of finance to benefit from greater efficiency and accountability resulting from decentralization and increased sector funding.

Table 3: An illustrative water sector funding scenario - share of public funds

<table>
<thead>
<tr>
<th></th>
<th>Share of public funds in expenditure for</th>
<th>Public expenditure required as a share of total public expenditure (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Capital Investment</td>
<td>Operations And Maintenance</td>
</tr>
<tr>
<td>Rural</td>
<td>90%</td>
<td>0%</td>
</tr>
<tr>
<td>Urban</td>
<td>30%</td>
<td>0%</td>
</tr>
<tr>
<td>Total</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

Source: Based on WSP-AF analysis. Information on public expenditure is available only for 15 countries.

3. What actions are needed to improve priority for and the use of public resources?

Sustained priority of the sector in public budgets is crucial because public finance is likely to remain important for financing water and sanitation in most developing countries. Nevertheless, priority given to water and sanitation in public resource allocations is often low, as is especially apparent in the Poverty Reduction Strategy Papers (PRSPs), which are increasingly becoming the mechanisms for setting national policy agendas and mobilizing resources, especially in Sub-Saharan Africa. Because of the relative importance of public funds and the potential benefits associated with its appropriate use, it is necessary to improve the efficiency and effectiveness of public funds in the sector. Some key areas of action to increase (and sustain) allocations to water and sanitation in budgetary processes and to improve the use of public funds in the sector are:

- There is a need to develop government-led medium-term sector programs; improve coordination of donor interventions to increase efficiency and effectiveness of public expenditure and; for the sector to better align itself with the PRSP and budget process. The water and sanitation sector in most countries is characterized by broad national policy development, and implementation through fragmented, often isolated projects - with the two efforts not effectively linked. A countrywide medium-term sector program is emerging as a necessary tool to link policy and implementation – a sector program (within a sector-wide approach (SWAP) requires that all major funding of the sector supports one coordinated policy and expenditure framework under government leadership. The alignment of donor approaches with country procedures is important for developing successful sector programs, especially in the absence of credible PRSP and budget processes. Off-budget donor interventions (through NGOs) also need to be aligned with government policy to avoid

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13 Mehta and Fugelsnes 2003.
14 Ibid. and Williamson 2004.
duplication and overlap.\textsuperscript{15} Appropriate self-coordination mechanisms among NGOs, such as those by UWASNET in Uganda, may provide good practice examples.

\textbf{Sector performance monitoring systems need to be strengthened.} For the sector to compete in the PRSP and medium-term budget process, it needs to show results through performance based monitoring. Though there are many initiatives (such as PRSP monitoring, budget tracking at ministries of finance, water point mapping, management information system projects), these are fragmented, isolated, and often project based. Improved frameworks are needed for input-output-outcome-impact monitoring and evaluation that are also integrated with the overall planning and budgeting systems by imposing a detailed and explicit presentation of expected results and allowing fine-tuning future activities on the basis of past experience. Monitoring and evaluation also promote accountability of those implementing policies and sector programs. Recently initiated efforts in performance monitoring in Uganda water sector will provide local experience to draw on in the future. WSP Africa also intends to support this through performance monitoring linked to its support for MDG Road Maps.

\textbf{Continuing advocacy efforts at global, regional, national and local levels are needed.} As politics determines budget priorities and many sectors compete for allocations in national and local government budgets, engagement in the political process is critical. Tailored advocacy strategies are important for the sector to argue its case in the budget process, and to retain gained priority at national and local levels. The case for water and sanitation needs to be made in terms of its contribution to poverty reduction and to various MDGs.\textsuperscript{16} Such efforts need to be complemented by more rigorous research on fiscal and economic returns of investment in water and sanitation.

\textbf{Allocation principles in the sector need to be improved.} Rules for allocation and access to public finance need to be developed in response to sub-sector priorities while developing a financing strategy. One key area is to better understand and balance rural and urban demands. As the unit cost of service in rural areas is less than in urban, it may be argued that targeted rural interventions are the least-cost approach to reaching the MDGs. This however ignores the economic costs associated with poor access in concentrated urban areas, and the contribution of urbanization to economic growth. Assuming, therefore, that for a country to meet the MDGs it must meet them in both rural and urban areas, rural spending requirements will constitute, on average, 36 percent of the total requirements in the water sector, despite current higher population levels in rural areas in Africa. In the sanitation sub-sector, however, rural costs will occupy over half of the total spending, due to the assumed reliance, even in urban areas, on on-site sanitation.

Figure 3 illustrates the issues in allocation across rural and urban sub-sectors in Ethiopia and Zambia. Between 16 and 73 times as much money is spent on targeting under-served populations in urban areas in Ethiopia and Zambia, respectively (using JMP coverage figures). Despite several assumptions, this analysis does give a picture of the spending patterns in some of the Sub-Saharan African countries. In Ethiopia, according to the analysis, capital investments on water fall short in both rural and urban areas, rural spending requirements will constitute, on average, 36 percent of the total requirements in the water sector, despite current higher population levels in rural areas in Africa. In the sanitation sub-sector, however, rural costs will occupy over half of the total spending, due to the assumed reliance, even in urban areas, on on-site sanitation.

\begin{itemize}
\item \textsuperscript{15} NGO resources are significant as shown in the Kenya and Ethiopia finance studies where the off-budget resources amounted to about 20 \% of total sector expenditure.
\item \textsuperscript{16} See Brocklehurst 2004 as an illustration.
\end{itemize}
question is more of efficiency and effectiveness in the use of resources. It is important to note that the high urban expenditure in Zambia may also reflect the rehabilitation of infrastructure taken up under sector reform, which has not been possible to capture in this analysis.

**Figure 3: Capital expenditure (per unserved capita) required and investment in water: rural versus urban**

<table>
<thead>
<tr>
<th></th>
<th>Ethiopia</th>
<th>Zambia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Urban expenditure</td>
<td>$9.06</td>
<td>$161.29</td>
</tr>
<tr>
<td>Urban requirement</td>
<td>$12.98</td>
<td></td>
</tr>
<tr>
<td>Rural expenditure</td>
<td>$0.54</td>
<td>$2.18</td>
</tr>
<tr>
<td>Rural requirement</td>
<td>$2.03</td>
<td></td>
</tr>
</tbody>
</table>


Use of justified access subsidies needs to be strengthened through improved design and innovations such as output-based aid. Traditional systems of subsidies in the water and sanitation sector often lack transparency and are not well targeted. The recent literature recognizes that ‘access subsidies’ are often necessary to ensure that the poor are not excluded due to affordability concerns, but emphasizes that subsidies need to be carefully designed to provide the right incentives and reach the ‘right’ target groups. Though there are successful examples of the use of access subsidies in rural water supply, publicly-funded demand promotion for sanitation and sustainable use of subsidized social connections in urban settings, there is limited innovation and use of output-based aid in the sector.

4. **Leveraging additional non-public resources into the sector**

The use of non-public resources (from communities and users, domestic financial markets and the private sector) in the water and sanitation sector is important for two reasons. First, the use of non-public resources will necessitate demand-responsiveness and consumer orientation in service delivery and market rigor in financial management – which will result in more efficient, effective and sustainable use of resources and improved service delivery. Second, and as more commonly argued, levered additional resources will enable the sector to attain economically feasible levels of expenditure (say 2 to 3 percent of GDP) within the ceiling for allocations in public expenditure under the MTEF framework.

There are three important ways to leverage resources for the sector – and all require institutional reforms that ensure autonomy to water service providers: a) from communities and households, through capital cost contributions and user charges, b) by market borrowing for capital investments by creditworthy service providers – utilities and small private or community based providers, and c) participation of private sector to improve efficiency or as direct service providers themselves. Some key areas of action to

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18 See Mehta 2003 for several examples and a discussion of issues in the use of such subsidies.
support sustainable leveraging of non-public resources – actual sequencing of these measures will depend on the specific country situation – are:

**Institutional and financial reforms need to be implemented to provide incentives for service providers to respond to consumer demand.** Poor coverage and level of service are often caused by a mismatch between users’ demands and the services delivered due to supply-driven planning for water services with national or regional targets forming the basis for investments. In response, public transfers/subsidies are often used to remedy lack of service, but without appropriate mechanisms for targeting of resource, resulting in perverse incentives that make accountability and demand-orientation redundant. To make water service providers respond to users’ demand and incorporating those into investment planning, financially autonomous service providers are critical as well as the use of performance linked partial capital grants. In rural water supply the emphasis needs to be on linking capital subsidies to demand-responsive approaches that require informed local choices backed by partial capital cost sharing.\(^{19}\)

**Efficiency and creditworthiness of utilities need to be improved to ensure internal cash generation - as a first step to mobilizing resources from the domestic credit markets.** Local credit markets are increasingly seen as an important source for leveraging non-public resources. This, however, requires creditworthy borrowers. Key steps for building creditworthiness include: ring-fencing of water revenues and maintaining a steady income stream through scrupulous revenue collection; implementing adequate accounting, disclosure, and reporting standards; using transparent and predictable intergovernmental transfers; and building staff capacity to manage and operate water and sewer systems. In addition, a strong and transparent legal framework must be in place.\(^{20}\) It is also critical that user (tariff) and community contributions are maximized, since they constitute a potentially large source of non-public finance to the sector. In many cases, poor management systems, often supported through de facto government guarantees, do not allow their full potential to be realized. Where tariff levels are below cost recovery levels, increases to allow for the recovery of all major costs are needed. Such tariff revisions, if done gradually, as was done in Guinea,\(^{21}\) can reduce the political cost of such actions.

**Appropriate policy and regulatory frameworks need to be implemented.** To mitigate undue risks in lending for water and sanitation sector as well as to provide incentives for maximizing user charges appropriate regulatory frameworks are essential. The regulator should be transparent and independent of the government with participation of sector stakeholders in the regulatory process. Policy frameworks should clearly separate the roles of sector actors to provide for accountability, and legal basis of different water service providers. For instance, unless the law recognizes the legal basis/franchise of service providers, their access to private capital will be constrained. Financing and cost sharing rules should be carefully designed to reflect the possibility of crowding in private and market-based resources.

**For sustainable mobilization resources from domestic markets and the private sector, support is required in meeting the initial transaction costs and capacity building of all stakeholders.** It is critical to support the development of initial precedents for commercial borrowing. This is critical to

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\(^{19}\) See Mehta 2003 for a discussion of use of access subsidies in demand-responsive approaches in rural water supply.

\(^{20}\) Brook and Locussol 2001.

\(^{21}\) See Mehta 2003.
create a greater interest among potential domestic lenders and private firms in the sector, and to develop local understanding of key issues in project development and risk assessment and mitigation. High initial transaction costs will need to be supported by either the government or donors. The nature of support will depend on the specific country situation in terms of level of financial and private sector development, but may include measures such as: project support facilities, specialized financial intermediaries, partial guarantees to cover policy risks, and specific capacity building support to lenders, small private firms and communities. This support infrastructure will enable a conversion of creditworthiness to bankable opportunities.

**A good information system is needed to enhance transparency and reduce risk perceptions among potential lenders and private service providers.** Because of the past reliance on public resources, the sector is often inadequately understood by financial and private players. Independent and credible information is needed to create an interest in the sector and help reduce the risk perception. This could be done through regional comparative performance reviews (supported) by regional entities such as the New partnership for Africa’s Development (NEPAD) or the Water Utility Partnership (WUP) as well as credit assessments of utilities by private credit rating agencies.

### 5. Way Forward

The key financing challenge in meeting the MDG targets is to arrive at consensus-based country level financing strategies integrated with the overall national planning and expenditure process. Key actions for different stakeholders include:

**Country and sub-national governments:**

- To develop investment and financing strategies to enable national or sub-national governments to review sector financing against policy scenarios (allocation principles, transfer mechanisms, rural/urban and water/sanitation issues, technology choices, etc) and develop financing mechanisms to provide the right incentives for reforms and support measures to leverage non-public resources into the sector
- To develop appropriate information and performance monitoring systems to guide future sector interventions and to help the sector arguing its case in the budget bidding process

**Regional institutions:**

- To encourage regional sector performance assessments to enable learning among countries
- To advocate for the sector at regional and global level, and support country advocacy strategies

**Donors**

- To harmonize programs and strategies among key sector donors at a country level to better align with government owned sector strategy and program

**Civil society organizations:**

- To coordinate their own activities to continue to spearhead reforms and support advocacy for increased priority of water and sanitation in planning and allocation of government resources
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WSP MISSION
To help the poor gain sustained access to improved water and sanitation services.

WSP FUNDING PARTNERS
The Governments of Australia, Austria, Belgium, Canada, Denmark, Germany, Italy, Japan, Luxembourg, the Netherlands, Norway, Sweden, Switzerland, and the United Kingdom, the United Nations Development Programme, and The World Bank.

ACKNOWLEDGEMENTS

We are grateful for the feedback provided by Jean Doyen and Darren Saywell on the initial drafts of this paper.

Production Assistance: Florence Makokha

The WSP Working Papers disseminate the findings of work in progress to encourage the exchange of lessons and experiences on water and sanitation issues. An objective of the series is to get the findings out quickly, even if the presentations are less than fully polished. The findings, interpretations, and conclusions expressed in the papers are entirely those of the authors. Dissemination of the material is encouraged and the Water and Sanitation Program will normally grant permission promptly. For questions about this report, including permission to reprint portions or information about ordering more copies, please contact the Water and Sanitation Program by email. The WSP Working Papers are available online at http://www.wsp.org/